

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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## SALT

### SUBJECT

## MASSACHUSETTS FINAL REGULATIONS ACCOMPANY ITS MARKET-BASED SOURCING APPORTIONMENT LAW

### SUMMARY

On January 2, 2015, the Massachusetts Department of Revenue (the “Department”) repealed and replaced section 63.38.1 of title 830 of the Code of Massachusetts Regulations (the “Market-Based Sourcing Regulation”) to supplement the market-based sales sourcing apportionment law applied to receipts from sales of other than tangible personal property under section 38(f) of chapter 63 of the General Laws of the Commonwealth of Massachusetts (the “Market-Based Sourcing Law”), which was enacted July 24, 2013.<sup>1</sup> The Market-Based Sourcing Regulation is very lengthy and provides detailed rules pertaining to assigning a receipt from the sale of other than tangible personal property, including a sale of an in-person service, a transportation/delivery service, and a professional service, as well as licensing, leasing, and selling of intangible property, among others. The receipts-assignment rules under the Market-Based Sourcing Regulation are effective for taxable years beginning on or after January 1, 2014, which is the same as effective date of the Market-Based Sourcing Law.<sup>2</sup>

### DETAILS

#### Background

The Market-Based Sourcing Law set the following framework for assigning receipts from sales of other than tangible personal property receipts to Massachusetts and adopted the concept of reasonable approximation where the state or states to which sales should be assigned cannot be determined:

- Sale, rental, lease, or license of real property, to the extent the property is located in the state;
- Rental, lease, or license of tangible personal property, to the extent the property is located in the state;
- Sale of a service, if and to the extent the service is “delivered” to a location in the state;



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<sup>1</sup> See also Mass. Ch. 36 (H.B. 3535), Acts of 2013.

<sup>2</sup> Mass. Regs. Code tit. 830, § 63.38.1(14).

- Lease or license of intangible property, to the extent the intangible property is used in the state; and
- Sale of intangible property, excluded from the numerator and the denominator of the sales factor.<sup>3</sup>

For taxable years beginning before January 1, 2014, the foregoing receipts are assigned to Massachusetts if the greater proportion of the income-producing activity was performed in Massachusetts, based upon costs of performance.<sup>4</sup> Before and after the enactment of the Market-Based Sourcing Law, receipts from sales of tangible personal property are sourced based upon destination.<sup>5</sup>

### Assignment Rules Under the Regulation

The charts on the following pages summarize many rules for assigning receipts to Massachusetts under the Market-Based Sourcing Regulation. The assignment provisions related to the sale, lease, rental, lease, or license of real and tangible personal property, corporate partners, and section 38 manufacturers<sup>6</sup> remain largely unchanged and have thus been omitted.<sup>7</sup>

In applying the rules under the Market-Based Sourcing Regulation, a taxpayer is required to use objective criteria, consider all available information, use the methodology that most accurately assigns sales, and make a reasonable effort to apply the rule before it may approximate the amount of sales assigned to a state.<sup>8</sup> Lastly, the Market-Based Sourcing Regulation makes extensive use of examples for purposes of demonstrating the application of the following rules and generally prohibits modifying an assignment methodology once it has been applied on an originally filed return.<sup>9</sup>

### Other Noteworthy Aspects of the Regulation

**Throwout Rule.** Under the Market-Based Sourcing Regulation (as well as under the Market-Based Sourcing Law), where a taxpayer cannot ascertain the state to which a sale of other than tangible personal property should be assigned, including under the reasonable approximation rules, the taxpayer must exclude the sale from the numerator and denominator of the sales factor - a throwout rule.<sup>10</sup> Also under the Market-Based Sourcing Regulation (as well as under the Market-Based Sourcing Law), a throwout rule applies to sales of other than tangible personal property where the taxpayer is not taxable in a state to which the sale is assigned.<sup>11</sup> For purposes of determining whether a taxpayer that is a member of a combined reporting group is taxable in a state, under the Market-Based Sourcing Regulation (as well as under the Market-Based Sourcing Law), if any member of the combined group is taxable in a state to which the sale is assigned, then every member of the combined group is deemed to be taxable in that state (*i.e.*, a *Finnigan* approach).<sup>12</sup>

**Reasonable Approximation and Unassigned Sales.** Many of the assignment provisions in the Market-Based Sourcing Regulation permit a taxpayer to reasonably approximate to which state a receipt should be assigned where the state of assignment cannot be determined under the rules provided. Where permitted, and if provided, the taxpayer is required to follow the reasonable approximation rule(s) applicable to the receipt at issue.<sup>13</sup> However, in the case of an unassigned receipt from a sale of a service, the taxpayer is required to assign the sale in the same proportion as assigned sales where the taxpayer is able to ascertain the state of assignment of a substantial portion of its sales of substantially similar services and the taxpayer reasonably believes the geographic distribution of the unassigned sale tracks the geographic distribution of the assigned sales.<sup>14</sup> The same rule applies to a license or sale of intangible property where the substance of the transaction resembles a sale of goods or services.<sup>15</sup>

**Changes in Methodology.** Under the Market-Based Sourcing Regulation, once a taxpayer files an original return for a taxable year in which it properly assigns the receipts from a sale, neither the taxpayer nor the Department may modify the assignment methodology for that taxable year, except to correct for factual or calculation errors.<sup>16</sup> With respect to

<sup>3</sup> Mass. Gen. Laws ch. 63, § 38(f) (effective for taxable years beginning on or after January 1, 2014).

<sup>4</sup> Mass. Gen. Laws ch. 63, § 38(f) (effective for taxable years beginning before January 1, 2014).

<sup>5</sup> Mass. Gen. Laws ch. 63, § 38(f).

<sup>6</sup> As used in the regulation, the term “section 38 manufacturer” means a corporation that is a manufacturing corporation within the meaning of Mass. Gen. Laws ch. 63, § 38(l)(1).

<sup>7</sup> See Mass. Regs. Code tit. 830, § 63.38.1(9)(d)2-7. See also Mass. Regs. Code tit. 830, § 63.38.1(10), (12).

<sup>8</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.d.i-iii.

<sup>9</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.e.i.

<sup>10</sup> Mass. Gen. Law ch. 63, § 38.1(f); Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.f.i.

<sup>11</sup> Mass. Gen. Law ch. 63, § 38.1(f); Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.f.ii.

<sup>12</sup> Mass. Gen. Law ch. 63, § 32B(d)(2)(iv); Mass. Regs. Code tit. 830, § 63.38.1(5)(c).

<sup>13</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.e.i.

<sup>14</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.e.ii.

<sup>15</sup> *Id.*

<sup>16</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.i.

prospectively filed returns, a taxpayer may only change an assignment methodology to improve the accuracy of reporting.<sup>17</sup> In the event a taxpayer opts to change an assignment methodology on a prospectively filed return, the taxpayer must disclose the change and retain documents that explain the nature and extent of the change and provide them to the Department upon request.<sup>18</sup> If the taxpayer fails to disclose the change or retain or provide the appropriate records, the Department may substitute an assignment methodology it determines is appropriate.<sup>19</sup> Similar to taxpayers, the Department may also modify an assignment methodology on a prospectively filed return where it determines the change is appropriate to reflect a more accurate assignment of the taxpayer's sales and the methodology can be reasonably adopted by the taxpayer.<sup>20</sup>

**Department Review and Adjustment.** The Market-Based Sourcing Regulation provides the Department with the authority to: (1) adjust a sale assignment in accordance with the rules under the Market-Based Sourcing Regulation where the taxpayer failed to assign a sale as required or retain or provide the appropriate records, or where the Department concludes that the taxpayer's customer's billing address was selected for tax avoidance purposes;<sup>21</sup> (2) substitute a method of approximation or exclude sales from the numerator or denominator of the sales factor where the Department determines that the method of approximation employed by the taxpayer is unreasonable;<sup>22</sup> (3) require a taxpayer to use a reasonable method of approximation in a consistent manner where it has not been applied in a consistent manner with respect to similar transactions or on a year-to-year basis;<sup>23</sup> and (4) apply a method of approximation to sales a taxpayer excluded from the numerator and denominator of the sales factor on the basis that such sales cannot be reasonably approximated.<sup>24</sup>

**Industry Specific Provisions.** With respect to motor carriers, airlines, and courier and package delivery services, the sales factor is now determined pursuant to the Market-Based Sourcing Regulation as applied to transportation and delivery services.<sup>25</sup> Other industry-specific apportionment guidance continues to be addressed through the applicable regulatory provisions, such as section 63.38.8 of title 830 of the Code of Massachusetts Regulations ("CMR") (Apportionment of Income of Pipeline Companies), section 63.38.10 of title 830 of the CMR (Apportionment of Income of Electric Industry), and section 63.38.11 of title 830 of the CMR (Apportionment of Income of Telecommunications Industry - except to the extent the provisions under section 63.38.1 of title 830 of the CMR pertaining to the sale or license of digital goods and services apply).<sup>26</sup>

**Other Regulations Amended.** While not specifically addressed herein, the Department also amended section 63.38.2 of title 830 of the CMR (Apportionment of Income of Airline Corporations), section 63.38.3 of title 830 of the CMR (Apportionment of Income of Motor Carriers), section 63.38.4 of title 830 of the CMR (Apportionment of Income of Courier and Package Delivery Services), and section 63.39.1 of title 830 of the CMR (Corporate Nexus), which reflect updates to be consistent with the Market-Based Sourcing Regulation.

## BDO INSIGHTS

- With the enactment of the Market-Based Sourcing Law in 2013, Massachusetts switched from a costs of performance/income-producing activity sales assignment methodology to a market-based sourcing methodology as it pertains to receipts from sales of other than tangible personal property and became one of approximately 15 other states that presently assign receipts from the sale of other than tangible personal property using a market-based approach. The general motivation behind such a switch is to shift at least a portion of the tax burden to out-of-state corporations that do not perform the service in-state. Adoption of a market-based approach to sourcing sales of other than tangible personal property has the added benefit of making in-state investment and hiring decisions more income tax neutral because the sales factor is no longer affected by costs incurred as it is under a costs of performance/income-producing activity methodology. More states are likely to switch to market-based sourcing (and single sales factor apportionment) in order to improve their position in the race for in-state investment and hiring.

<sup>17</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.iii.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.iv.

<sup>21</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.ii.(A), (E), and (F).

<sup>22</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.ii.(B).

<sup>23</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.ii.(C).

<sup>24</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.ii.(D).

<sup>25</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)4.b.iii.

<sup>26</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.h.i.

- The sourcing and assignment rules under the Market-Based Sourcing Regulation are extremely detailed and complex. On the one hand, this complexity facilitates a comprehensive sales sourcing regime with rules that address a myriad of business types and industries. In addition, the reasonable approximation rules and safe harbor rules should give taxpayers some sense of comfort with respect to those situations where recordkeeping may be less than perfect or does not otherwise facilitate conformity with the general assignment rules. On the other hand, the devil is in the details, and, as such, the efficacy of these detailed and complex rules in practice will be tested in the upcoming filing season and beyond.
- As noted above, once a taxpayer adopts a proper assignment methodology on an originally filed return, the taxpayer may not modify the assignment methodology on an amended or future taxable year's return except to correct for factual or calculation errors or to improve accuracy.<sup>27</sup> Even then, if the taxpayer opts to modify an assignment methodology, it must disclose the change.<sup>28</sup> Taken together, these provisions place a heavy burden on the taxpayer to get the assignment methodology "right" the first time (*i.e.*, on the first return filed after the 2013 taxable year) or risk having to rationalize a change to the Department on grounds that justify modifying an assignment methodology or, even worse, the Department rejecting the change and seemingly being "stuck" with a less than desirable assignment methodology.
- Taxpayers and the Department do not appear to have equal rights under the Market-Based Sourcing Regulation. On the one hand, the Market-Based Sourcing Regulation provides that, once a taxpayer adopts a proper assignment methodology on an original return, neither the taxpayer nor the Department may modify the taxpayer's methodology for assigning such sales on an amended return or otherwise (except for in the limited circumstances noted above).<sup>29</sup> On the other hand, however, the Department may substitute a method of assignment where it determines an assignment methodology is not reasonable-seemingly without regard to whether the assignment methodology may be proper under the Market-Based Sourcing Regulation.<sup>30</sup> In a January 2, 2015, letter addressed to Jessica Seney, Director of Government Affairs, Greater Boston Chamber of Commerce, and Bradley A. MacDougall, Vice President-Government Affairs, Associated Industries of Massachusetts, Michael T. Fatale, Chief-Rulings and Regulations Bureau, the Department addressed this concern by noting: (1) under the Market-Based Sourcing Regulation, neither the Department nor a taxpayer may modify a taxpayer's methodology retrospectively where the taxpayer has properly assigned its sales, including where the taxpayer has used a method of reasonable approximation that is in accordance with the rules under the Market-Based Sourcing Regulation; and (2) this apparent inequity is necessary as part of the Department's audit process, which does not allow for the Department and taxpayers to be on an "equal footing." Only time will tell how and to what extent the Department utilizes this authority.

<sup>27</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.i and iii.

<sup>28</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.iii.

<sup>29</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.i.

<sup>30</sup> Mass. Regs. Code tit. 830, § 63.38.1(9)(d)1.g.ii.(B).

Receipt From ...	Source to Massachusetts ...
<b>NON-PROFESSIONAL, IN-PERSON SERVICES (DIRECTLY/INDIRECTLY PROVIDED BY THE TAXPAYER)</b>	
... Performed on the body of a person	... If the customer is located in Massachusetts
... Performed in the physical presence of a customer	... If the customer is located in Massachusetts
... Performed on real estate	... If the property is located in Massachusetts
... Performed on non-shipped tangible personal property	... If the property is located in Massachusetts
... Performed on shipped tangible personal property	... If the property is shipped/delivered to a customer located in Massachusetts
<b>PROFESSIONAL SERVICES</b>	
... General - provided to an individual customer and < 5% of the taxpayer's sales of services are from the customer	... If Massachusetts is the customer's state of primary residence, or, if not identifiable, the customer's billing address is in Massachusetts
... General - provided to an individual customer and > 5% of the taxpayer's sales of services are from the customer	... If Massachusetts is the customer's primary state of residence
... General - provided to a business customer and < 5% of the taxpayer's sales of services are from the customer	... If: (i) the customer principally manages the contract in Massachusetts, (ii) if not reasonably determinable, the customer placed the order in Massachusetts, (iii) if not reasonably determinable, the customer's billing address is in Massachusetts
... General - provided to a business customer and > 5% of the taxpayer's sales of services are from the customer	... If the customer principally manages the contract in Massachusetts
... General - provided to an individual or business customer optional safe harbor (if substantially similar service transactions with > 250 customers and < 5% of the taxpayer's sales of services are from the customer)	... If Massachusetts is the customer's billing address
... Architectural services - real estate improvements	... If the property located or expected to be located in Massachusetts
... Architectural services - other	... As required under the general professional services rules
... Engineering services - real and tangible personal property	... If the property located or expected to be located in Massachusetts
... Engineering services - other	... As required under the general professional services rules
... Financial institution services - receipts not otherwise apportioned under M.G.L. c. § 63, 2A	... As required under the general professional services rules
<b>NON-IN-PERSON AND NON-PROFESSIONAL SERVICES DELIVERED TO THE CUSTOMER ON BEHALF OF THE CUSTOMER OR DELIVERED ELECTRONICALLY THROUGH THE CUSTOMER</b>	
... Delivery to or on behalf of a customer by physical means - individual or business customer	... To the extent the service is actually delivered to the customer or the customer's customer is in Massachusetts or, if not indeterminable or insufficient information, by reasonable approximation based upon information available regarding place of delivery
... Delivery to a customer by electronic transmission - individual customer	... To the extent the customer actually receives the service in Massachusetts or, if not indeterminable or insufficient information, by reasonable approximation as follows (in order of priority): (i) based upon sufficient information regarding the customer's place of receipt; or (ii) if insufficient information regarding place of receipt, based upon the customer's billing address
... Delivery to a customer by electronic transmission - business customer	... To the extent the service is directly used by the customer's employees or designees in Massachusetts or, if not reasonably determinable, reasonably approximate as follows (in order of priority): (i) if sufficient information regarding location where directly used by the customer's employees or designees, based upon the location where directly used by the customer's employees or designees; (ii) if insufficient information, as follows (in order of priority): a. based upon where the contract is principally managed by the customer, b. if not reasonably determinable, based upon the customer's place of order, or c., if not reasonably determinable, based upon the customer's billing



Receipt From ...	Source to Massachusetts ...
	address (but must use state where the customer principally managed the contract if more than 5% of sales of services are from that customer); or (iii) where engaged in substantially similar transactions with more than 250 customers, does not derive more than 5% of sales from the customer and cannot reasonably approximate under (i), may assign on the basis of the customer's billing address
... Delivery through or on behalf of a customer through electronic transmission - general rule	... To the extent the end-user or other third-party recipient is actually in Massachusetts, or, if not determinable, by reasonable approximation based upon sufficient information regarding place of delivery.
... Delivery through or on behalf of a customer through electronic transmission - customer is a reseller	... To the extent the end-user or other third-party recipients receive such services in Massachusetts, or, if not determinable, reasonably approximate as follows (in order of priority): (i) based upon sufficient information regarding place of delivery, or (ii) if insufficient information, based upon a percentage that reflects the ratio of the Massachusetts geographic area in which the customer reseller resells such services relative to the total population in such area.
... Delivery through or on behalf of a customer through electronic transmission - advertising service	... To the extent the audience for the advertising is in Massachusetts, or, if insufficient information, reasonably approximate as follows (in order of priority): (i) based upon the location of the audience, or (ii), if insufficient information, based upon a percentage that reflects the ratio of the Massachusetts's population in the specific geographic area in which the advertising is delivered relative to the total population in such area.
<b>TRANSPORTATION AND DELIVERY SERVICES</b>	
... Provided exclusively by air	... Using the following formula: receipts x [percentage of aircraft departures occurring in Massachusetts/everywhere aircraft departures] ( <u>Note</u> : Where the service is provided by multiple aircraft types, the calculation must be weighted by the values of the aircraft types as provided under the revised Apportionment of Income of Airlines regulation).
... Provided by means other than exclusively by air - people	... Using the following formula: receipts x [percentage of Massachusetts departures and arrivals/everywhere departures and arrivals]
... Provided by means other than exclusively by air - tangible personal property	... Using the following formula: receipts x [percentage of Massachusetts pick-ups and deliveries/everywhere pick-ups and deliveries]
<b>INTANGIBLE PROPERTY</b>	
... License/lease - marketing intangible with actual evidence	... To the extent receipts are attributable to Massachusetts
... License/lease - marketing intangible without actual evidence and use relates to retail customers	... Using the following formula: fee x percentage that reflects the ratio of the Massachusetts population in the geographic area in which the licensee makes use of the intangible property to market goods/services relative to the total population in such area
... License/lease - marketing intangible without actual evidence and use relates to wholesale customers	... Using the following formula: fee x percentage that reflects the ratio of the Massachusetts population in the geographic area in which the licensee's goods/services are ultimately marketed relative to the total population in such area
... License/lease - production intangible initial presumption	... If the customer's state of commercial domicile is Massachusetts (business licensee) or Massachusetts is the customer's state of primary residence (individual licensee), except to the extent the taxpayer can demonstrate the actual location of a portion of the use takes place outside Massachusetts
... License/lease - mixed marketing and production intangible (fees separately stated)	... As required under the rule applicable to each revenue stream
... License/lease - mixed marketing and production intangible (fees not separately stated)	... As required under the marketing intangible rules (except to the extent the Department or the taxpayer can establish otherwise)

Receipt From ...	Source to Massachusetts ...
... License/lease - resembles a sale of goods/services	... As required under the rules pertaining to either: (i) the delivery to a customer by electronic transmission, or (ii) the delivery of services electronically through or on behalf of a customer
... Sale of an intangible - contract right or government license that authorizes business activity in a specific geographic area	... To the extent the intangible property is used or associated with Massachusetts through reasonable approximation
... Sale of an intangible - agreement not to compete	... Using the following formula: receipts x percentage that reflects Massachusetts population in the U.S. geographic area specified in the contract relative to the total population in the U.S. geographic area specified in the contract
... Sale of an intangible - resembles a license	... As required under the license/lease of intangible property rules
... Sale of an intangible - resembles a sale of goods/services	... As required under the license/lease of an intangible that resembles a sale of goods/services rules
... Sale of an intangible - excluded sales	... Exclude the following from the numerator and denominator of the sales factor: (i) securities, (ii) business goodwill, (iii) going concern value, (iv) workforce in place, (v) partnership interest that is not a security, and (vi) any other intangible not referenced in 830 C.M.R. § 63.38.1(9)(d)6.a.i, ii, iii, iv or v.
<b>SPECIAL RULES</b>	
... Software transferred via tangible medium	... As required under the tangible personal property sourcing rules
... Software all other cases	... As otherwise required under the intangible personal property sourcing rules.

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